

# Taxation: Creation of an Accountant Work-Product Privilege for Tax Accrual Workpapers. *United States v. Arthur Young and Co.*, 104 S. Ct. 1495 (1984)

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## NOTES

**TAXATION — Creation of an Accountant Work-Product Privilege for Tax Accrual Workpapers.** *United States v. Arthur Young & Co.*, 104 S. Ct. 1495 (1984).

Section 7602 of the Internal Revenue Code<sup>1</sup> provides the Internal Revenue Service (IRS) with the ability to summon a wide variety of corporate taxpayer records.<sup>2</sup> Recently, a controversy has developed because certified public accountants (CPA's) have resisted disclosure of tax accrual workpapers to the IRS.<sup>3</sup> Tax accrual workpapers are docu-

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1. Section 7602(a) provides:

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized —

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for the tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

I.R.C. § 7602(a) (1982) (as amended by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III § 333(a), 96 Stat. 622 (1982)).

2. See, e.g., *United States v. Euge*, 444 U.S. 707 (1980) (handwriting exemplars); *United States v. Bisceglia*, 420 U.S. 141 (1975) ("John Doe" summons to discover identity of a bank depositor enforced); *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978) (internal audit reports), *cert. denied*, 441 U.S. 923 (1979); *United States v. Davey*, 543 F.2d 996 (2d Cir. 1976) (computer tapes); *Foster v. United States*, 265 F.2d 183 (2d Cir.) (bank signature cards, cancelled checks, and ledger sheets), *cert. denied*, 360 U.S. 912 (1959).

3. See, e.g., Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194 (1979); Garbic & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66 (1982); Moses, *Issuance and Enforcement of I.R.S. Summonses Against Third-Party Record Keepers*, 60 TAXES 66, 72-79 (1981); *I.R.S. Eyes Accountants' Workpapers*, 67 A.B.A. J. 1703 (1981); Note, *Government Access to Corporate Documents and Auditor's*

ments prepared by a corporation's independent auditor in the course of the regular financial audits required by federal securities laws.<sup>4</sup> These workpapers include valuable evaluations and analyses of a corporation's contingent tax liability,<sup>5</sup> but are not used in the preparation of the corporate tax return.<sup>6</sup>

In *United States v. Arthur Young & Co.*<sup>7</sup> the United States Supreme Court ordered enforcement of an IRS summons of workpapers.<sup>8</sup> The Court held that the independent auditors' tax accrual workpapers were relevant to an IRS tax investigation of the Amerada Hess Corporation<sup>9</sup> and refused to protect the workpapers through a judicially created accountant work-product privilege.<sup>10</sup> In rendering this decision, the Supreme Court sought to resolve the disagreement among lower courts on the issues of the relevancy of the workpapers to IRS investigations and whether the workpapers should be privileged.

This Note will analyze the *Arthur Young* decision, its rationale, and its impact. Section I will provide a statement of the case. Section II will present essential background information, and section III will analyze the Court's decision and its reasoning. The Note concludes with a call for congressional action to protect the strong policy interests affected by the Court's decision.

## I. THE CASE

The certified public accounting firm of Arthur Young & Company audited and certified the Amerada Hess Corporation's financial statements for the period of 1972 through

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*Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. LAW 349, 356 (1977).

4. See *United States v. Arthur Young & Co.*, 104 S. Ct. 1495, 1499-1500 (1984); Caplin, *supra* note 3, at 194.

5. *Arthur Young & Co.*, 104 S. Ct. at 1500. See Caplin, *I.R.S. Toughens its Stance on Summoning Accountants' Tax Accrual Workpapers*, 53 J. TAX'N 130, 130 (1980).

6. See *United States v. Coopers & Lybrand*, 550 F.2d 615, 621 (10th Cir. 1977); Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 VA. TAX REV. 57, 69 (1981); Caplin, *supra* note 5; Caplin, *supra* note 3, at 194.

7. 104 S. Ct. 1495 (1984).

8. See *id.* at 1505.

9. See *id.* at 1502.

10. See *id.* at 1505.

1974.<sup>11</sup> Publicly owned companies like Amerada Hess are required to undergo annual audits and certification of their financial statements in order to comply with requirements of the Securities and Exchange Commission (SEC).<sup>12</sup> The IRS, during a routine audit of Amerada's income tax liability for the period of 1972 through 1974, uncovered a questionable payment.<sup>13</sup> As a result, the IRS instituted a criminal investigation.<sup>14</sup> As part of the joint civil and criminal investigation, the IRS issued a summons, pursuant to section 7602, requesting Arthur Young's tax accrual workpapers regarding the Amerada Hess Corporation for the years 1972 through 1974.<sup>15</sup> Because Arthur Young refused to comply with the summons, the IRS commenced an action in federal district court in an effort to obtain judicial enforcement.<sup>16</sup> The district court ordered enforcement of the summons,<sup>17</sup> holding that the tax accrual workpapers were relevant to an IRS tax investigation,<sup>18</sup> and refused to protect the workpapers through recognition of an accountant-client privilege.<sup>19</sup>

A divided Second Circuit Court of Appeals reversed the district court's order enforcing the summons.<sup>20</sup> The court, utilizing the prevailing Second Circuit relevancy test,<sup>21</sup> agreed with the district court that the CPA's tax accrual

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11. *United States v. Arthur Young & Co.*, 104 S. Ct. 1495, 1498 (1984).

12. See Regulation S-X, 17 C.F.R. § 210.5-02(25) (1981). The SEC requires the filing of financial statements as part of: (1) registration statements under the Securities Act of 1933, Schedule A (25) - (27), 15 U.S.C. § 77aa (1982); (2) registration statements under the Securities Exchange Act of 1934, ch. 404 §§ 12(b)(1)(J)-(L), 12(g)(1), 48 Stat. 892, 15 U.S.C. §§ 78k(b)(1)(J)-(L), 78k(g)(1) (1982); (3) proxy and information statements under the Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n (1982); Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1982); and (4) annual reports under the Securities Exchange Act of 1934, §§ 13(a)(2), 15(d), 15 U.S.C. §§ 78m(a)(2), 78o(d) (1982); 17 C.F.R. §§ 249.310, 249.460 (1982).

13. *Arthur Young*, 104 S. Ct. at 1498.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* at 1499.

18. *Id.*

19. *Id.*

20. *United States v. Arthur Young & Co.*, 677 F.2d 211, 214 (2d Cir. 1982), *aff'd in part and rev'd in part*, 104 S. Ct. 1495 (1984).

21. *Id.* at 218. For an expression of this test, see *infra* text accompanying note 22. This standard has been consistently used by the Second Circuit. See, e.g., *United States v. Noall*, 587 F.2d 123, 125-26 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979); *United States v. Shlom*, 420 F.2d 263, 265 (2d Cir. 1969), *cert. denied*, 397 U.S. 1074

workpapers were relevant under section 7602 because the workpapers "might have thrown light upon the correctness of the taxpayer's return."<sup>22</sup>

However, the court of appeals majority, in a departure from the district court decision, fashioned an accountant work-product privilege for tax accrual workpapers prepared in connection with the audit of a publicly held company.<sup>23</sup> The court noted that disclosure of an auditor's tax accrual workpapers would provide the IRS with an unfair advantage in litigation with the corporate taxpayer.<sup>24</sup> In addition, the court concluded that the public interest in candid communication between corporation management and the auditor would be threatened and, as a result, would increase the likelihood of inaccurate financial statements.<sup>25</sup> As a consequence, the court created an accountant work-product privilege in order to protect the integrity of the securities markets.<sup>26</sup>

The United States Supreme Court granted certiorari,<sup>27</sup> and in an unanimous decision, affirmed the Second Circuit's ruling on the relevance of the tax accrual workpapers to an IRS tax investigation.<sup>28</sup> However, the Court reversed the Second Circuit's ruling which protected the tax accrual workpapers under a judicially created work-product immunity.<sup>29</sup>

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(1970); *Foster v. United States*, 265 F.2d 183, 186-87 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959).

22. *Arthur Young*, 677 F.2d at 218-19.

23. *See id.* at 221.

24. *See id.* at 220.

25. *Id.* at 219.

26. *Id.* at 219-21. Judge Newman, dissenting, argued against the creation of a work-product privilege for the tax accrual workpapers. Creation of an accountant work-product privilege is a matter for Congress, not the courts, according to Newman. In addition, he disputed the policy arguments purported by the majority. *Id.* at 221-24 (Newman, J., dissenting).

27. *United States v. Arthur Young & Co.*, 103 S. Ct. 1180 (1983).

28. *See Arthur Young*, 104 S. Ct. at 1502.

29. *See id.* at 1505.

## II. BACKGROUND

### A. *The Certified Public Accountant's Audit*

A CPA audits a company to render an opinion as to whether the company's financial statements fairly present the financial position of the company. An accountant's audit also includes the results of the company's operations and any changes in its financial position for the period under audit.<sup>30</sup> The auditor must conduct the audit in compliance with generally accepted auditing standards<sup>31</sup> and determine

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30. See generally AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), A Professional Standards (CCH) AU § 509 (June 1, 1984). There are four kinds of auditors' opinions: (1) "An *unqualified opinion* states that the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (GAAP) consistently applied." *Id.* at AU § 509.28; (2) An *adverse opinion* is rendered when the financial statements are not fairly presented. *Id.* at AU § 509.41; (3) "A *disclaimer of opinion* states that the auditor does not express an opinion on the financial statements." *Id.* at AU § 509.45; (4) "A *qualified opinion* states that, 'except for' or 'subject to' the effects of the matter to which the qualification relates," the financial statements are fairly presented. *Id.* at AU § 509.29.

31. Generally Accepted Auditing Standards (GAAS) are adopted by the American Institute of Certified Public Accountants (AICPA) and published in the Statements on Auditing Standards (SAS). GAAS deal with the auditor's professional qualities and judgment exercised in the performance of his examination and report. *Id.* at AU §§ 150.01 to 150.02. The GAAS are:

#### *General Standards*

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

#### *Standards of Field Work*

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

#### *Standards of Reporting*

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

whether the corporation's financial statements conform to generally accepted accounting principles.<sup>32</sup>

Generally accepted accounting principles require an auditor to analyze a company's contingent liabilities.<sup>33</sup> The potential for assessment of additional taxes, resulting from a deficiency in tax liability as reported on the corporate return, represents one type of contingent liability.<sup>34</sup> An auditor

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4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

AICPA, A Professional Standards (CCH) AU § 150.02 (June 1, 1984).

32. "Generally accepted accounting principles (GAAP) constitute at a given point in time a consensus of how financial transactions should be recorded." D. KIESO & J. WEYGANT, *INTERMEDIATE ACCOUNTING* 44 (2d ed. 1977). GAAP includes detailed accounting procedures. *Id.* at 45.

"Auditing 'standards' differ from auditing 'procedures' in that 'procedures' relate to the acts to be performed, whereas 'standards' deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken." AICPA, A Professional Standards (CCH) AU § 150.01 (June 1, 1984).

Generally Accepted Accounting Principles (GAAP) include Statements on Financial Accounting Standards promulgated by the AICPA's Financial Accounting Standards Board (FASB, formerly the Accounting Principles Board) in conjunction with certain Accounting Research Bulletins and APB opinions which are not superseded by FASB statements. AICPA, B Professional Standards (CCH) ET § 203.03 (June 1, 1984). In addition, GAAP includes "practices having general acceptance but which are not covered in any official pronouncement." J. ROBERTSON, *AUDITING* 47 (1st ed. 1976).

33. FASB Accounting Standards Current Text C59.101 (June 1, 1984) (incorporating FASB 5, as amended) provides: "[A] contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." *Id.*

34. See W. MEIGS, E. LARSEN & R. MEIGS, *PRINCIPLES OF AUDITING* 605-06 (6th ed. 1977). This possible future tax assessment is attributable, in part, to the subjective nature of the Code provisions and, as a consequence, the varying interpretations given to the Code provisions by the taxpayer and the IRS. See, e.g., *United States v. El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1982) ("The income tax laws, as every citizen knows, are far from a model of clarity."), *cert. denied*, 104 S. Ct. 1927 (1984); *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982) (The tax code "is not cast in black and white . . .").

The liability is also dependent on the occurrence of an IRS audit of the taxpayer's return. Therefore, before the filing of the corporate tax return and the settlement of the tax liability as the result of an IRS audit, the corporation incurs a contingent liability. W. MEIGS, E. LARSEN & R. MEIGS, *supra* note 34, at 605-06.

must estimate the probability of an IRS audit<sup>35</sup> and the magnitude of a future tax assessment.<sup>36</sup> An evaluation of the magnitude of a tax deficiency requires an auditor to prepare a "worst-case" analysis.<sup>37</sup> The independent auditor's analysis of the corporation's contingent tax liability is documented in the tax accrual workpapers.<sup>38</sup>

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35. A large corporate taxpayer has a high probability of being audited. *See, e.g., United States v. El Paso Co.*, 682 F.2d 530, 533 (5th Cir. 1982) (audited every year since 1940s), *cert. denied*, 104 S. Ct. 1927 (1984); *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 949 (D. Colo. 1975) (audited every year since 1913), *aff'd*, 550 F.2d 615 (10th Cir. 1977). *See also Kurtz & Panel, Discussion on "Questionable Positions," 32 Tax Law. 13, 15 (1978)* (IRS audits 100% of returns for the largest corporations).

36. FASB Accounting Standards Current Text C59.105 (June 1, 1984).

37. *See AICPA, A Professional Standards (CCH) AU § 337.05* (June 1, 1984). M. Stone, Past President of the AICPA, testified that the worst case analysis determines

what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.

He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with . . . .

*United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). *See also Caplin, supra* note 3, at 195; Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561, 1571 (1981).

38. Tax accrual workpapers include:

(1) discussions by the CPA with officials and/or legal counsel of the taxpayer of tax return reporting positions which may be controversial, either because of close factual questions or because of uncertain statutory, administrative or judicial authority; (2) analysis of possible positions or courses that the IRS might take or pursue upon examination of the return; (3) evaluation of the hazards of litigation on these issues, separately or in the aggregate; (4) an estimation of the additional tax that might result from an administrative settlement or litigation; (5) opinion letters from legal counsel concerning proposed transactions or pending income tax return controversies and forecasting possible outcomes; (6) accounting and/or legal analyses of issues that might be controverted, and expert accounting and/or legal opinions as to the propriety of the records maintained and the tax return positions taken; (7) various speculations, theories, estimates, conjectures, ideas, and other interpretive and judgmental materials used to analyze such issues and make recommendations thereon; (8) predictions as to pending legislation and evolving administrative interpretations; (9) consideration of possible requests for letter rulings; (10) memoranda and research of pertinent authorities; and (11) communications between and among the taxpayer, his legal counsel, and his independent auditors on any or all of the above matters.

Diss, *The IRS and Auditors' Tax Workpapers: How Far Is Too Far?*, ARTHUR YOUNG J. 10, 15 (Summer & Autumn 1976).

The workpapers, whether initially prepared by the corporation or the auditor, are the property of the CPA. They are, however, subject to ethical limitations vis-a-vis



### B. The Dispute

Corporate taxpayers, CPA's, and the IRS have become entangled in litigation regarding the ability of the IRS to summon, under section 7602, the auditor's tax accrual workpapers. CPA's argue that IRS access to the tax accrual workpapers will impair auditor-client communications<sup>39</sup> and, as a consequence, will thwart performance of a satisfactory audit.<sup>40</sup> A corporation will withhold vital information from the auditor to avoid supplying the IRS with a "road map" of the "soft spots" in the corporation's tax return.<sup>41</sup> Inquiries and candid discussions with management constitute indispensable evidentiary tools enabling the auditor to more accurately ascertain a corporation's financial health.<sup>42</sup> An accurate assessment of a company's financial position cannot be gleaned solely from an analysis of accounting

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confidential relationships with clients. AICPA, A Professional Standards (CCH) AU § 339.06 (June 1, 1984).

39. See, e.g., *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 953-54 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977). A past president of the AICPA, Mr. Stone, testified:

Now, these are the kinds of problems which we are continually in contact with our client about, are advising the client, are getting his feedback. If we were hampered in any audit situation by the fact that the client knows that if he gives us any data about that that it's going to be readily available to the Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication, and if I were the client, I would be the first to admit that that is the way I would feel.

413 F. Supp. at 954. See also *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

40. See, e.g., *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 1000 n.6 (N.D. Ill. 1981); *United States v. Coopers & Lybrand*, 413 F. Supp. 953 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); Caplin, *supra* note 3, at 199; Garbis & Struntz, *supra* note 3, at 67.

41. *United States v. El Paso Co.*, 682 F.2d 530, 545 (5th Cir. 1982), *cert. denied*, 104 S. Ct. 1927. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); *United States v. Coopers & Lybrand*, 550 F.2d 615, 621 (10th Cir. 1977); *United States v. Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973); Caplin, *supra* note 5, at 130; Caplin, *supra* note 3, at 194.

42. According to the third Standard of Field Work of Generally Accepted Auditing Standards, "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation." AICPA, A Professional Standards (CCH) AU § 150.02.

records.<sup>43</sup> Ultimately, the client's failure to provide an auditor with the information necessary to make an accurate assessment of the corporation's contingent tax liability will result in the transmittal of inaccurate financial data to the investing public.<sup>44</sup>

Corporate taxpayers contend that disclosure of their tax accrual workpapers reveals their negotiation strategies and settlement positions and would, therefore, provide the IRS with an unfair advantage in litigating disputes.<sup>45</sup> Corporations also argue that they possess a legitimate "expectation of privacy" in sensitive information documented in tax accrual workpapers.<sup>46</sup>

On the other hand, the IRS views tax accrual workpapers as an invaluable investigative tool that can prevent a corporate taxpayer from hiding questionable tax positions among an overwhelming number of business transactions and records.<sup>47</sup> Therefore, the IRS needs the tax accrual workpapers as a "road map" highlighting the corporation's tax positions and allowing for a more efficient investigation.<sup>48</sup> Also, the corporation is more likely to discuss "questionable areas" with the auditor than an IRS agent.<sup>49</sup> Therefore, the tax accrual workpapers provide the IRS with a more thorough evaluation of the corporation. Furthermore, the IRS contends that the summons of a corporation's tax accrual workpapers is consistent with the IRS's broad investigatory powers.<sup>50</sup>

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43. See Note, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604, 609.

44. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982). See also Hanson & Brown, *CPAs' Workpapers: The IRS Zeroes In*, J. ACCT. 68, 70 (July 1981).

45. See, e.g., *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

46. See *id.* at 219-20; *United States v. Coopers & Lybrand*, 413 F. Supp. 942, 944 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977); Caplin, *supra* note 3, at 199.

47. Hanson & Brown, *supra* note 44, at 70; Kurtz & Panel, *supra* note 35, at 15 (good chance questionable tax positions will not be found). Accord *United States v. El Paso Co.*, 682 F.2d 530, 533 (5th Cir. 1982), *cert. denied*, 104 S. Ct. 1927 (1984).

48. See *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982); Caplin, *supra* note 5, at 130; Note, *supra* note 43, at 606.

49. See Note, *supra* note 43, at 609.

50. The IRS summons power has been referred to as "inquisitorial." See, e.g., *United States v. Bisceglia*, 420 U.S. 141, 147 (1975); *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *Falsone v. United States*, 205 F.2d 734, 737 (5th Cir.), *cert.*

*C. Disagreement Among the Courts*

There is wide disagreement among courts regarding the resolution of this controversy. The development of the law in this area hinges on three principal cases. In *United States v. Coopers & Lybrand*<sup>51</sup> the Tenth Circuit was the first appeals court to address the validity of an IRS summons of tax accrual workpapers under section 7602.<sup>52</sup> The court denied the IRS access to a CPA's tax accrual workpapers, ruling that the workpapers were not relevant within the context of section 7602.<sup>53</sup> In appraising section 7602 relevance, the court considered whether the summoned information was used in preparing the corporation's income tax return.<sup>54</sup>

In *United States v. Pennington*<sup>55</sup> the Eleventh Circuit ruled that the independent auditor's tax accrual workpapers were relevant to an IRS investigation of a corporation's tax liability.<sup>56</sup> The court employed a test that determined whether the information "might throw light upon the correctness of the taxpayer's return; and more narrowly, whether there is an indication of a realistic expectation rather than an idle hope that something might be discovered."<sup>57</sup> The court of appeals refused to create a work product privilege.<sup>58</sup> Instead, it felt that Congress was the proper

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*denied*, 346 U.S. 864 (1953). The IRS summons power has also been analogized to that of a grand jury. See, e.g., *United States v. Bisceglia*, 420 U.S. 141, 147 (1975); *United States v. Rosinsky*, 547 F.2d 249, 252-53 (4th Cir. 1977); *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States v. Ryan*, 455 F.2d 728, 733 (9th Cir. 1972); *United States v. Widelski*, 452 F.2d 1, 4 (6th Cir. 1971), *cert. denied*, 406 U.S. 918 (1972); *Foster v. United States*, 265 F.2d 183, 186-87 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959). See generally *Fink, Internal Revenue Service Summons Power*, 38 N.Y.U. INST. FED. TAX §§ 19.01-.08 (1980).

51. 550 F.2d 615 (10th Cir. 1977).

52. See *id.* at 620-21.

53. See *id.* at 621.

54. See *id.* at 619. The court also incorporated policy arguments into its relevancy decision considering the fairness of imposing "unnecessary burdens on the taxpayer . . . where there is no indication of an attempt to escape liability." *Id.* at 621 (quoting *United States v. Matras*, 487 F.2d 1271, 1274-75 (8th Cir. 1973)).

55. 718 F.2d 1015 (11th Cir. 1983).

56. See *id.* at 1020.

57. *Id.* at 1019 (quoting *United States v. Wyatt*, 637 F.2d 293, 300-01 (5th Cir. 1981)).

58. See 718 F.2d at 1021.

body to make any decision to limit IRS summons power.<sup>59</sup>

In *United States v. Arthur Andersen*<sup>60</sup> the Massachusetts District Court held that an independent auditor's tax accrual workpapers were relevant in regard to a section 7602 summons.<sup>61</sup> The court devised a relevancy standard based on whether there was an "indication of realistic expectation rather than an idle hope something may be discovered" in the workpapers.<sup>62</sup> The court held that an IRS agent's "collective familiarity" with taxpayer records constituted a "realistic expectation."<sup>63</sup>

### III. ANALYSIS

In *United States v. Arthur Young & Co.*<sup>64</sup> the Supreme Court held that the IRS has the authority to summon, under section 7602, an independent certified public accountant's tax accrual workpapers prepared in the course of a corporation's annual financial audit.<sup>65</sup> The Court rested its decision, in part, on the relevance of the independent auditor's tax accrual workpapers to the IRS's investigation of corporate tax liability.<sup>66</sup> The Court also ruled that a CPA's tax accrual workpapers will not be protected from an IRS section 7602 summons through a judicially created accountant work-

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59. *See id.* The workpapers in this case were prepared by an independent auditor of a closely held corporation. Therefore, the court adamantly refused to protect the workpapers due to the absence of countervailing policies. *See id.*

60. 474 F. Supp. 322 (D. Mass 1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

61. *See id.* at 329-30.

62. *Id.*

63. *Id.* The court rejected the relevancy criteria established by the Tenth Circuit in *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), because it felt that whether the information was used in preparing the corporate tax return should not be determinative in evaluating relevance. In addition, unlike the Tenth Circuit's relevancy standard, the *Arthur Andersen* court did not consider policy considerations as factors which input into a decision regarding § 7602 relevancy. 474 F. Supp. at 326-27.

The corporate taxpayer and CPA in the *Arthur Andersen* case argued for a judicially created accountant-client privilege which would protect the confidentiality of auditor-client communications, and more specifically, the tax accrual workpapers. The court refused to create this privilege. *See id.*

64. 104 S. Ct. 1495 (1984).

65. *See id.* at 1505.

66. *See id.* at 1501-02.

product privilege.<sup>67</sup>

An examination of these holdings reveals the inadequacies in the Court's approach. Due to this decision's inevitable impact upon the securities market, Congress must take action to restrict IRS summons authority.

### A. Relevancy

The Court ruled that items of "potential relevance to an ongoing [IRS] investigation" are within section 7602's meaning of "relevant."<sup>68</sup> The Court's formulation of the relevancy standard is inadequate for several reasons. First, the test provides essentially no limitation upon IRS summons authority and therefore allows the Service to enjoy unlimited investigative power.<sup>69</sup> Furthermore, the language of section 7602(a) requires a showing of "relevance . . . to such inquiry."<sup>70</sup> The context of the section 7602 inquiry refers to the "correctness of any return," not the performance of the investigation itself.<sup>71</sup> Therefore, the standard established by the court is overbroad.

In addition, the plain meaning of the statute indicates that factual materials are relevant and that nonfactual opinions and thoughts are not relevant.<sup>72</sup> Consequently, the non-

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67. See *id.* at 1504.

68. *Id.* at 1501. The Court noted that the relevancy standard used in determining whether items are admissible in federal court is not to be used in an evaluation of the relevance of an IRS summons. The Court stressed that a finding of relevance will not be barred solely because the tax accrual workpapers are not used in the preparation of the tax return. Although the language is different, the Court has essentially adopted the Second Circuit's "might throw light" relevancy standard. See *supra* notes 21-22 and accompanying text. In effect, both standards provide the IRS with the authority to summon virtually anything remotely related to the taxes. No finding of "reasonable expectation" or other restriction is specified in the test. *Id.*

69. Under the Court's formulation of the relevancy standard, practically every corporate document would fall within the court's relevancy standard. The standard also conflicts with the Court's previous rulings which protect CPA's from "fishing expeditions" in their workpapers. See *United States v. Bisceglia*, 420 U.S. 141, 146 (1975). *Accord* *Reisman v. Caplin*, 375 U.S. 440, 445 (1964).

70. I.R.C. § 7609(a) (1984).

71. *United States v. El Paso Co.*, 682 F.2d 530, 546-47 (5th Cir. 1982) (Garwood, J., dissenting).

72. See *Caplin*, *supra* note 3, at 199. Former Commissioner of Internal Revenue Mortimer Caplin stated, "[w]hat comes to mind in the use of that term [data] are items such as books, records, and other factual materials — not opinions, projections, conjectures and other thought processes." *Id.* See also *P.T. & L. Constr. Co. v. Com-*

factual opinions and speculations contained in the tax accrual workpapers are not within the plain meaning of the statute.

The Court relied heavily on the statutory language of section 7602 in establishing the relevancy test.<sup>73</sup> However, the notion of relevancy entails a weighing of factors<sup>74</sup> on a "case-by-case" basis.<sup>75</sup> Although the Court recognized one policy factor — the importance of broad summons authority to revenue collection<sup>76</sup> — the Court ignored other policy factors, such as public interest in preventing disclosure of confidential information.<sup>77</sup>

Lastly, the Court noted that the broad summons authority of the IRS is critical to the IRS's ability to perform its

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missioner, 63 T.C. 404, 414 (1974) ("[m]ental impressions, legal analysis, conclusions, and recommendations are generally not relevant.").

73. "The language 'may be' reflects Congress' express intention to allow the IRS to obtain items of even potential relevance . . ." *Arthur Young*, 104 S. Ct. at 1501.

74. See C. McCORMICK, *HANDBOOK OF THE LAW OF EVIDENCE* § 77, at 159-60 (2d ed. 1972). The author stated:

Reconciling interests in privacy and confidentiality with the needs of litigants is not readily achieved in terms of broad categories; it calls for the finer touch of the specific solution. A tool already at hand, though perhaps largely unrecognized, consists of recognizing standing on the part of the possessor of information to question the legitimacy of need for it in litigation, i.e., to raise issues of relevancy in the broad sense. A similar thread runs through the Federal Rules of Civil Procedure limitation of discovery to matters "relevant to the subject matter involved in the pending action." Relevancy itself, of course, contemplates a process of weighing, and inevitably the judge must be accorded a substantial measure of discretion.

See also Caplin, *supra* note 6, at 65 ("relevance varies with a number of factors"); Comment, *Internal Revenue Service Accessibility to Auditors' Tax Accrual Workpapers*, 72 GEO. L.J. 1211, 1227-28 (1984) (advocating a relevancy standard which balances conflicting policy considerations); Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 381-82 (1977); Note, *Auditor-Client Work-Product Privilege With Respect to Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437, 453-54 (1983); Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185, 203-05 (1982).

75. *United States v. Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973). See also Caplin, *supra* note 6, at 65 ("particular kind of document may be relevant in one context but not in another"); Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185, 203 (1982). See generally James, *Relevancy, Probability and the Law*, 29 CALIF. L. REV. 689, 690 (1941).

76. See *Arthur Young*, 104 S. Ct. at 1501.

77. See *supra* notes 39-44 and accompanying text.

function.<sup>78</sup> Therefore, the Court rejected a narrower definition of relevance.<sup>79</sup> However, the companies themselves possess most of the information the IRS is seeking from the tax accrual workpapers.<sup>80</sup> This availability diffuses the IRS's "critical need" to summon the CPA's tax accrual workpapers.

### *B. Accountant Work-Product Privilege*

#### 1. Congressional Intent for Judicial Review over IRS Summons Authority

The Court interpreted the language in section 7602 as reflecting "a congressional policy choice in favor of disclosure of all information relevant to the legitimate IRS inquiry."<sup>81</sup> According to the Court this broad authority should not be restricted by the courts in the absence of "traditional privileges and limitations,"<sup>82</sup> or "unambiguous directions from Congress."<sup>83</sup> The Court found no such directions from Congress supporting the creation of an accountant work-product immunity.<sup>84</sup> The Court emphasized that any restriction on the IRS summons authority "is a choice for Congress, and not this Court . . . ."<sup>85</sup>

Although Congress gave the IRS broad summons authority, Congress did not make the summons power self-executing; instead, Congress provided for review by the courts as a check on potential abuse of summons power by the IRS.<sup>86</sup> Therefore, the Court's decision to reject limitations on IRS summons power conflicts with clear congressional

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78. *Arthur Young*, 104 S. Ct. at 1501.

79. *See id.*

80. Auditors disclose material problems in the tax accrual analysis to the company. *See Chazen, Miller & Solomon, When the Rules Say "See Your Lawyer"*, J. ACCT. 60, 66-70 (Jan. 1981). *See also* *United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1982) ("[t]he corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability").

81. *Arthur Young*, 104 S. Ct. at 1502 (emphasis omitted).

82. *Id.* (quoting *United States v. Euge*, 444 U.S. 707, 714 (1980)).

83. 104 S. Ct. at 1502 (quoting *United States v. Bisceglia*, 420 U.S. 141, 150 (1975)).

84. 104 S. Ct. at 1502.

85. *Id.*

86. *Reisman v. Caplin*, 375 U.S. 440, 445-46 (1964). *See* *United States v. Powell*, 379 U.S. 48, 58 (1964).

intent to provide for judicial review over IRS summons authority.<sup>87</sup>

## 2. Substantial Policy Considerations Require Protection of Tax Accrual Workpapers

The Court determined that the work-product privilege, recognized by the court of appeals, was "misplaced" because the desired remedy, preservation of candid auditor-client communication, "more closely resembled a testimonial accountant-client privilege . . . ."<sup>88</sup> Therefore, the tax accrual workpapers would be subject to an IRS summons because an accountant-client privilege has not been recognized under

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87. In addition, according to respondent's brief, congressional enactment of Section 6661 of the Tax Equity and Financial Responsibility Act (TEFRA) of 1982 provides evidence that Congress has chosen to support protection of the independent auditor's tax accrual workpapers from an IRS summons through the creation of an accountant work-product privilege for them. Brief for Respondent at 30-33, *United States v. Arthur Young & Co.*, 104 S. Ct. 1495 (1984). The Second Circuit urged Congress to "require that this material be made available, or that taxpayers flag their questionable positions directly on their returns," if it concluded that the tax accrual workpaper privilege would result in an excessive limitation on the function of the IRS. *United States v. Arthur Young & Co.*, 677 F.2d 211, 221 (2d Cir. 1982). Congress subsequently enacted Section 6661 of TEFRA which levies a penalty for the understatement of tax liability unless the taxpayer reveals on the tax return the relevant facts underlying questionable tax positions. Because the Section 6661 provisions dealt exclusively with relevant factual data revealed on the return, there is evidence that Congress intends to exclude from the IRS any opinions located in the tax accrual workpapers. Furthermore, the penalties prescribed by statute 6661 merely provide an incentive encouraging voluntary taxpayer revelations. Disclosure, according to the congressional scheme of revenue collection, is ultimately left to the discretion of the taxpayer rather than compelled, as in the case of a summons of tax accrual workpapers. See I.R.C. § 6661 (1984).

Also, Congress did not enact legislation in § 6661 to remove the previously established accountant's tax accrual workpaper immunity created by the Second Circuit. It has been held that the failure of Congress to amend legislation constitutes confirmation of accepted judicial interpretations of unrevised legislation. *Cf. Herman & MacLean v. Huddleston*, 103 S. Ct. 683, 689 (1983) (failure of Congress to act while amending securities laws considered to be a confirmation of accepted judicial interpretations of the unrevised legislation).

The legislative history further evidences the nexus between Section 6661 and Section 7602. The Senate Committee on Finance reported, "the committee intends that the Secretary shall in no event require the disclosure of accountant's work papers." S. REP. NO. 494, 97th Cong., 2d Sess. 274, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 1021. The considerable relationship between Section 6661 and Section 7602 provides a strong indication that congressional action in response to the Court's decision regarding the tax accrual workpapers will be forthcoming.

88. *Arthur Young*, 104 S. Ct. at 1503.



federal law, and "no state created privilege has been recognized in federal cases."<sup>89</sup> However, the work-product privilege is designed to protect thought processes, mental impressions, and opinions.<sup>90</sup> Accountant-client communication is protected as incident to protecting the thought processes.<sup>91</sup>

The Court also rejected the argument that the accountant work-product privilege is analogous to an attorney's work-product privilege because of the CPA's role as a "public watchdog."<sup>92</sup> However, if corporate management is not can-

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89. *Couch v. United States*, 409 U.S. 322, 335 (1973). Sixteen states have statutes establishing an accountant-client privilege. See Note, *An Appraisal of Arthur Young: A Valuable Privilege for Accountants*, 48 ALB. L. REV. 109, 142 n.193 (1983). See also *Falsone v. United States*, 205 F.2d 734, 740-42 (5th Cir.), cert. denied, 346 U.S. 864 (1953); Katsoris, *Confidential Communications — The Accountants' Dilemma*, 35 FORDHAM L. REV. 51, 67-68 (1966). See generally Note, *supra* note 3, at 369-73; Note, *Privileged Communications — Accountants and Accounting — A Critical Analysis of Accountant-Client Privilege Statutes*, 66 MICH. L. REV. 1264 (1968).

90. *Upjohn Co. v. United States*, 449 U.S. 383, 400 (1981). See *United States v. Nobles*, 422 U.S. 225, 238 (1975).

91. *Upjohn*, 449 U.S. at 400. In *Hickman v. Taylor*, 329 U.S. 495 (1947), attorney-client communication was not classified as a testimonial privilege instead of a "work-product" privilege. *Id.* at 510-11. See generally Cohn, *The Work-Product Doctrine: Protection, Not Privilege*, 71 GEO. L.J. 917, 922-25 (1983) (distinguishing testimonial attorney privilege from attorney work-product).

92. *Arthur Young*, 104 S. Ct. at 1503.

The Court also speculated that the creation of tax workpaper immunity might impair the public's perception of the auditors' responsibilities as "watchdogs" and consequently undermine the integrity of the securities market. *Id.* at 1504 n.15. Since the work-product privilege has traditionally been limited to attorneys in their role as advocates, the auditor might also be perceived as an advocate, favoring the client's interests over those of the general public. However, there is no conflict in ideology as a result of extending the work-product privilege from advocates, such as attorneys, to public accountants whose role is viewed as independent. Both the accountant and attorney work-product privileges protect "thought processes essential to achieve important public policy . . . ." Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468-487 (1982). The attorney work-product privilege effectuates an "orderly working of our system of legal procedure." *Id.* (quoting *Hickman v. Taylor*, 329 U.S. 495, 512 (1947)). Likewise, the accountant work-product privilege safeguards the "national public interest [in] insur[ing] the maintenance of fair and honest markets in [securities] transactions." *United States v. Arthur Young & Co.*, 677 F.2d 211, 219 (1982) (quoting 15 U.S.C. § 786).

In addition, the AICPA's professional standards will preserve the accountants' independence despite the creation of a tax accrual work-product privilege. The independence standard provides: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." AICPA, A Professional Standards (CCH) AU § 150.02 (June 1, 1984). The threat of

did with the auditor, the auditor will not obtain sufficient evidence to perform the audit.<sup>93</sup> Instead, the analogy between an accountant's and attorney's work product is quite strong.<sup>94</sup>

According to the Court, the "integrity of the securities markets" would not suffer from the lack of workpaper protection because the auditor should not, and does not, rely solely on management's representations in preparing the audit.<sup>95</sup> However, the auditor, in order to properly evaluate the financial condition of the company, often cannot obtain the necessary information from any sources other than management.<sup>96</sup> The Court also believes that no company will risk receiving a qualified opinion as a result of restricting the scope of the auditor's examination.<sup>97</sup> But an auditor who does not know the information exists cannot know the information is missing; and as a result, the auditor will not be in a position to qualify the opinion.<sup>98</sup> Also, experience has shown that disclosure of a CPA's tax accrual workpapers results in strained communication between the auditor and the corporation undergoing the audit.<sup>99</sup>

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malpractice liability resulting from a breach of the independence standard provides accountants with sufficient incentive to maintain their independence.

The Court has failed to recognize the CPA's dual responsibilities of independence to the public and confidentiality to the client. According to the AICPA Code of Ethics, "A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client." AICPA, B Professional Standards (CCH) ET § 301.01 (June 1, 1984). AICPA standards demonstrate that independence is not jeopardized by privileges extended to auditor-client communication. Therefore, perception that the public would view the accountant as an advocate upon the establishment of a work-product privilege is unfounded.

93. See *infra* note 42 and accompanying text.

94. See Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185, 206-07 (1982) (observing that "the workpapers are a collection of potentially adverse legal theories compiled by the accountant").

95. *Arthur Young*, 104 S. Ct. at 1503.

96. *Id.* at 1503-04.

97. See *id.*

98. Note, *supra* note 43, at 610.

99. Hanson & Brown, *supra* note 44, at 68 ("IRS activity already has caused a deterioration of the accountant-client dialogue"). See also *Interpretation Guides Auditor Who Cannot Obtain Evidence on Income Tax Accruals*, J. ACCT. at 18, 20 (Mar. 1981); *Auditors Say IRS Demand for Documents Is Poisoning Relations with Client Firms*, WALL ST. J., Jan. 15, 1981, at 25, col. 4.

The Court also argues that the IRS has shown administrative sensitivity to the CPA's concerns, as evidenced by recent revisions in the IRS policy manual<sup>100</sup> tightening the requirements for issuance of a summons of tax accrual workpapers.<sup>101</sup> However, the IRS manual dictates service policy, but it does not provide the taxpayer with satisfactory protection.<sup>102</sup> Also, in light of the expansive relevancy standard adopted by the Court,<sup>103</sup> the IRS will be free to interpret the guidelines without meaningful judicial review.

#### IV. CONCLUSION

The Court's decision in *Arthur Young* will result in uniformity among lower courts concerning the ability of the IRS to summon, under section 7602, tax accrual workpapers prepared by a corporation's independent auditor. However, the Court's section 7602 relevancy standard gives unlimited summons authority to the IRS.<sup>104</sup> The Court's refusal to limit this broad IRS summons authority through judicial recognition of an accountant work-product privilege for a CPA's tax accrual workpapers will further deteriorate the auditor-client relationship and, consequently, threaten the integrity of the securities markets.<sup>105</sup> Therefore, congressional action is necessary to protect an independent auditor's tax accrual workpapers from an IRS section 7602 summons.<sup>106</sup>

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100. See I Int. Rev. Man. (Audit) (CCH) § 4024.4 (May 14, 1981).

101. See *Arthur Young*, 104 S. Ct. at 1504.

102. See *United States v. Caceres*, 440 U.S. 741 (1979) (evidence, obtained in violation of IRS procedures, was not required to be excluded from trial where constitutional or statutory rights were not affected); Parnell, *The Internal Revenue Manual: Its Utility and Legal Effect*, 32 TAX LAW. 687 (1979); Parnell, *Postscript — The Internal Revenue Manual: Its Utility and Legal Effect*, 33 TAX LAW. 341 (1979). See also *United States v. I.C. Industries, Inc.*, 555 F. Supp. 219, 222 (N.D. Ill. 1983); *United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 999 (N.D. Ill. 1981); *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, 331 (D. Mass. 1979).

103. See *supra* notes 68-69 and accompanying text.

104. See *supra* notes 68-69 and accompanying text.

105. See *supra* notes 95-99 and accompanying text.

106. The Securities and Exchange Commission and the investing public do not possess adequate mechanisms to insure candid auditor-client communication and accurate financial statements. The risk of shareholder suits and SEC investigations and

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ultimate prosecutions overlooks "the fact that the depth and quality of any investigations to ensure compliance with the law would suffer . . . ." *Upjohn Co. v. United States*, 449 U.S. 383, 392 n.2 (1981). Therefore, Congress should statutorily create a work-product privilege for tax accrual workpapers prepared in connection with an audit of a public company that is similar to the attorney's work-product privilege established in the Federal Rule of Civil Procedure 26. *See United States v. Arthur Young & Co.*, 677 F.2d 211, 220 (1982); Note, *supra* note 43, at 624-25. This privilege would protect "mental impressions, conclusions, opinions, and legal theories" contained in the tax accrual workpapers from IRS scrutiny; factual information incorporated in the tax accrual workpapers would be accessible upon a "showing that the party seeking discovery has substantial need of the materials . . . and that he is unable without undue hardship to obtain the substantial equivalent." *See* FED. R. CIV. P. 26(b)(3); Note, *supra* note 43, at 624-25. As former Commissioner of Internal Revenue Mortimer Caplin stated, "the primary source of the information is the taxpayer's records, these [tax accrual] workpapers are to be sought only sparingly and with discretion — and then only as a procedure of last resort." Caplin, *supra* note 3, at 199.